

Project Notes

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A Valuable Tool for Urban Reform in India: Technical Guide on Accounting and Financial Reporting by Urban Local Bodies

The Institute of Chartered Accountants of India (ICAI) published a technical guide on accounting and financial reporting by urban local bodies in India in October 2000. The guide, prepared by a national committee representing both urban local bodies and the accounting profession, is an important tool for urban financial reform in India. The Indo-USAID FIRE project supported the conceptualization and development of this guide. This Project Note describes the origin of the guide, summarizes its contents, and outlines ICAI's plan to disseminate its recommendations.

At present, urban local bodies (ULBs) that seek to mobilize additional resources internally or from outside sources to meet growing infrastructure demands are severely constrained by a cash-based accounting system and financial statements. Cash-based accounting does permit monitoring of compliance with the prescribed use of funds and spending limits set in the budget. It does not, however, provide information about a ULB's financial position and performance required by financial analysts and decision-makers.

In order to increase available options for loans and other mechanisms to raise money, and enhance their capacity to negotiate favorable terms, ULBs need to present complete and reliable financial information. Only financial statements based on a double-entry accrual (or modified accrual) basis can provide users a statement of assets and liabilities (balance sheet) and matching revenue and expenditures statements. These financial statements enable users to determine not only effective compliance with budget conditions, but also the efficiency of municipal operations and the overall financial status of the

urban body. Consequently, many states, cities and national organizations are making serious efforts to study, develop and implement new accounting systems, standards and reporting formats for ULBs in India.

The Institute of Chartered Accountants of India and Its New Role

One of the most important efforts to reform municipal accounting in India is being led by the Institute of Chartered Accountants of India. ICAI is well positioned for this challenge due to its historical mandate and the wide distribution of its members throughout India. The ICAI was established on July 1, 1949 under The Chartered Accountants Act, 1949 to regulate the accounting profession in India. Headquartered in New Delhi, a Central Council comprised of 30 members manages the Institute; members elect 24 and the central government appoints six. Regional Councils are located in Mumbai, Chennai, Calcutta, Kanpur and New Delhi and 87 branches of these councils are found

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throughout the country. (The Institute also has nine chapters in Africa and the Middle East.) The Institute's membership has grown to nearly 90,000 and 70 percent of its members are practicing accountants.

The Prime Minister of India, Mr. Atal Bihari Vajpayee, in a speech at ICAI's 50th anniversary celebration, acknowledged its valuable contribution in establishing accounting norms and standards for industries and commercial enterprises in India since the country's independence. Looking ahead, he challenged ICAI to take the lead in developing a proper financial accounting and reporting system for the social sector, which includes rural and urban local bodies in India. The ICAI is fulfilling its commitment to the urban sector by conducting the necessary research and developing materials to introduce an improved accounting system for ULBs.

Preparation of the Technical Guide

The Indo-USAID FIRE project realized the demand for an improved accounting system based on its experience assisting municipal corporations, other ULBs, and state agencies to introduce a commercial orientation in urban infrastructure services and to access private financing for them. In 1997, the FIRE project staff made a presentation to the ICAI's Professional Development Committee, which set up a five-member study group immediately after the presentation. This group was later expanded into a 12-member subcommittee of the Institute's Accounting Standards Board. Members included eminent accounting professionals and urban government officials. After detailed study of the practical problems faced by ULBs, the subcommittee prepared the *Technical Guide on Accounting and Financial Reporting by Urban Local Bodies*. The guide is intended to be a first step in the Institute's ongoing guidance to local officials. The FIRE project supported the subcommittee's efforts from its inception.

Contents of the Technical Guide

The purpose of the technical guide is to provide a broad framework for and direction to state governments, ULBs, ICAI members, and others as they work to improve urban accounting and financial reporting systems. Urban local bodies include municipal corporations, municipalities, and town panchayats. The chapters of the ICAI technical guide deal with the following issues:

- objectives of financial reporting by urban local bodies;
- basis of accounting measurements;
- accounting standards and their application to ULBs;

- issues in transitioning from present to suggested accounting systems;
- form and content of financial reports; and
- implementation.

The following paragraphs highlight the main points of each chapter.

Objectives. Financial reporting by urban local bodies is intended to satisfy the information needs of various users. The three principal user groups are the ULB itself, including elected officials; the public; and creditors owed for the provision of goods, services and loans. These groups need financial information to:

1. determine compliance with laws, rules, and regulations;
2. evaluate efficiency and effectiveness; and
3. assess financial position.

Basis of accounting. This phrase refers to the timing of recognition of revenues, expenses, assets, and liabilities in accounts. At present, ULBs in India are generally following the cash basis of accounting. Transactions are recorded – and revenues and expenses recognized – when the related cash receipts or cash payments take place. The cash basis of accounting fails to meet most of the financial reporting objectives. The limitations of the cash basis of accounting for assessing performance and financial position have led to the adoption of the accrual basis of accounting. Accrual accounting is the method of recording transactions by which revenues, costs, assets, and liabilities are recognized in the accounts in the period in which they occur. The guide also discusses a “modified accrual basis” of accounting. In this system, revenues and other increments to government funds are recognized in the accounting period in which they become both measurable and available to finance the expenditure of the fiscal period.

Accounting standards and their application. Accounting standards lay down the rules for measuring and presenting accounting information. They apply to any entity engaged in commercial, industrial or business activities, even if these activities are only a small portion of the entity's activities. The technical guide clarifies that these standards apply to ULBs since “virtually all ...do carry on some activities of a commercial or business nature, e.g. supply of water.” In order to address the particular problems of ULBs, each accounting standard and its applicability to ULBs in practical situations is discussed in Chapter 5, the core of the guide.

Transition. The major stumbling blocks for ULBs in the process of transition from a cash basis to an accrual basis of accounting are unrecorded assets and unrecorded liabilities. Based on field experience, FIRE staff estimates that unrecorded assets are a far greater

problem of the two for urban local bodies. In the accrual system, assets are recorded at the amount of expenditure to acquire or construct them, with costs amortized over their useful life. Under the current cash system of accounting, however, documents about the costs of fixed assets acquired or constructed in the past may not be available or the value of assets received as donations or endowments may have been recorded as “nil” since there was no cost to the urban body. The ICAI guide suggests using the estimated market value of these assets at the time of the transition to the new accrual system. Liabilities that may not be recorded under a cash system are pension payments and gratuities due to employees in the future. Obtaining an accurate record of all assets and liabilities is required to construct a balance sheet showing an entity’s financial position.

Formats of financial statements. Financial statements are the end product of the accounting process. Through them, financial information is communicated to various users to assist them in making economic decisions. For the information in the financial statements to be useful, it should have certain characteristics. The guide describes these qualities: understandability; relevance; materiality; reliability; faithful representation; substance over form; neutrality; prudence; completeness; and comparability. However, the guide recognizes that there are constraints to providing such relevant and reliable information in the financial statements. The constraints relate to timeliness and cost. If there is undue delay in the reporting of information, it may lose its relevance. And the benefits derived from disclosing the information must exceed the associated costs of providing it. All ULBs must grapple with these two constraints.

The recommended formats provide for the disclosure of aggregate figures of revenues, expenses, assets, and liabilities on the face of the balance sheet and the income and expenditure account. The guide recommends that these statements should also disclose relevant information for each type of activity to help users assess the efficiency and effectiveness of the ULB in carrying out different types of activities. Since many urban activities are not separately priced or are subsidized, this may require additional explanatory information. Finally, the guide encourages ULBs to present more than the minimum information required by the suggested formats. The purpose of the suggested formats is to bring uniformity to financial reporting that would allow users to make inter-and intra-state comparisons. However, ULBs and state governments are free to develop an accounting system within the ICAI framework and guidelines that meets their specific needs and requirements.

Implementation. Implementation of these suggestions would require widespread changes to the accounting systems currently in use in most ULBs. The success of

the move toward improved financial reporting depends to a large extent on how well the transition process is managed. The guide recommends that states and ULBs take the following principal steps to implement its suggestions:

- review the current legislative framework with regard to accounting systems;
- develop accounting manuals, starting with manuals already developed by other states;
- carry out common training programs for ULB accounting personnel;
- promote the participation of municipal personnel in the transition process;
- institute financial audits; and
- use the services of chartered accountants in implementing the new accounting system.

Implementation in Tamil Nadu and Other States

Tamil Nadu is the first state in India to introduce an accrual based accounting system in all municipalities and municipal corporations, which it did effective April 1, 2000. Tamil Nadu officials provided key input in the preparation of ICAI’s technical guide. The Institute and the FIRE project also provided technical assistance to those developing Tamil Nadu’s accounting system manual. Thus, Tamil Nadu and ICAI complemented each other in developing the state’s accounting system manual and the Institute’s technical guide. The FIRE project was the catalyst and supported both ICAI and Tamil Nadu in setting the overall framework for change and the practical example for other states in India to follow. The states of Karnataka, Maharashtra, Gujarat, Rajasthan, Andhra Pradesh, Madhya Pradesh, and Punjab are all making efforts at the state and city levels to improve their urban financial accounting systems.

ICAI Action Plan

Currently there is a great demand by local and state governments to adopt the new, generally accepted accounting principles and procedures for local governments in India. ICAI will continue to play a leadership role in this regard. The ICAI plans to continue its support of municipal accounting reforms by:

- continuing to formulate accounting standards applicable to urban local bodies and other similar government organizations. For this purpose, it will consider applicable laws, customs, practices, and the operating environment of local governments in India. It will also review the Government

Accounting Standards issued by the U.S. Government Accounting Standards Board.

- continuing to develop a comprehensive framework for preparation and presentation of financial statements by urban local bodies;
- issuing clarifications and interpretations of its Accounting Standards;
- producing *Guidance Notes* and other literature on accounting and financial reporting by urban local bodies;
- responding to the issues arising out of the implementation of the suggestions in its Technical Guide; and
- conducting workshops, training programs and seminars to provide guidance to local and state officials regarding implementation of these suggestions.

Conclusion

The primary purpose of local governments is to maximize the provision of urban services within available resources. Accordingly, urban bodies are accountable for their operational and fiscal performance to citizens, investors, lenders, and all other stakeholders. Operational accountability refers to the extent to which local governments have met their program objectives efficiently and effectively, given their resources. Fiscal accountability requires officials to demonstrate that their activities have complied with laws, rules, and regulations concerning the raising and spending of funds. Financial statements enable users to measure the degree to which a local government has met both requirements. With the introduction of the recommended changes in the basis and system of accounting, the financial statements of urban local bodies in India will be able to provide users with better information on the qualitative and quantitative aspects of a local government's performance.

G. P. Singh, Financial Management and Accounting Consultant to the FIRE project, wrote this *Project Note*. The *ICAI Technical Guide on Accounting and Financial Reporting by Urban Local Bodies* is available from the ICAI office in New Delhi and TCGI in Washington, DC. This *Project Note* complements Note No. 22 on the *Successful State-wide Reform Initiative in Tamil Nadu*. All *Project Notes* are available online at www.dec.org.

The mission of the Indo-US FIRE(D) Project is to institutionalize the delivery of commercially viable urban environmental infrastructure and services at the local, state and national levels. Since 1994, the Project has been working to support the development of demonstration projects and of a sustainable urban infrastructure finance system. Now, the Project is also pursuing this mission through:

- Expansion of the roles of the private sector, NGOs and CBOs in the development, delivery, operation and maintenance of urban environmental infrastructure;
- Increased efficiency in the operation and maintenance of existing water supply and sewerage systems;
- Strengthened financial management systems at the local level;
- Development of legal and regulatory frameworks at the state level;
- Continued implementation of the 74th Constitutional Amendment; and
- Capacity-building through the development of an Urban Management Training Network.

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